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Fourth BIS Annual Conference

Past and Future of Central Bank Cooperation

Basel, Switzerland, 27-29 June 2005

celebrating 75 years of the Bank for International Settlements, 1930-2005

Monday, 27 June 2005

Keynote dinner address

Tommaso Padoa-Schioppa, former member of the Executive Board, ECB

Tuesday, 28 June 2005

Opening remarks

William White, BIS

Chairman: Herman Baron Van Der Wee, Katholieke Universiteit Leuven

Session 1

One hundred and thirty years of central bank cooperation: a BIS perspective
Claudio Borio, BIS and Gianni Toniolo, University of Rome Tor Vergata, Duke University & CEPR

Discussants: Marc Flandreau, Institut d'Etudes Politiques, Paris
Miles Kahler, University of California, San Diego

Session 2

Almost a century of central bank cooperation
Richard Cooper, Harvard University

Discussants: Barry Eichengreen, University of California, Berkeley
Albrecht Ritschl, Humboldt-Universität zu Berlin

Chairman: Harold James, Princeton University

Session 3

Architects of stability? International cooperation among financial supervisors
Ethan Kapstein, INSEAD

Discussants: Charles Goodhart, London School of Economics
Peter Praet, National Bank of Belgium

Session 4

The future of central bank cooperation
Beth Simmons, Harvard University

Discussants: Michael Bordo, Rutgers University, New Brunswick
Edwin Truman, Institute for International Economics, Washington DC

Wednesday, 29 June 2005

Chairman: Paul De Grauwe, Katholieke Universiteit Leuven

Session 5

Central banks, governments and the European monetary unification process
Alexandre Lamfalussy

Discussants: Peter Kenen, Princeton University
Yung Chul Park, University of Korea

Policy panel discussion

Chairman: Malcolm D Knight, BIS

Reflections on the future of central bank cooperation

Participants: Andrew Crockett, J P Morgan Chase
Jacques de Larosière, Paribas
Allan Meltzer, Carnegie Mellon University
Paul Volcker, International Accounting Standards Committee
Yutaka Yamaguchi, former Deputy Governor, Bank of Japan

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Bank for International Settlements

Malcolm D Knight

William White

Claudio Borio

Piet Clement

Contents

Past and future of central bank cooperation

Opening remarks

W R White[1]

Let me begin this meeting by welcoming all of you, both central bankers and academics, to this conference on the "Past and future of central bank cooperation". This is the fourth in a series of annual conferences, all of which have been based on the premise that these two communities have a great deal to learn from each other. In particular, we feel that the central bankers, who are on the firing line of public policy, have some comparative advantage in identifying the issues that need analysis. The academics, in turn, have a similar advantage with respect to analytical tools, rigour and sometimes, quite simply, the time to do the thinking required.

In this spirit, **participation** in the conference this year does mark a further step forward. Whereas in the past we primarily invited academic economists and economic historians, this year we have extended the writ to a number of political scientists interested in political and other processes, and the development of institutions to support such processes. I am pleased about this, in part because I have felt for a long time (and I think there is evidence to back this up) that the multidisciplinary approach often leads to big breakthroughs in terms of understanding. But, more particularly, I am also pleased because it responds to a specific concern that I have had for many years here at the BIS. Namely that, as we were trying over the years to make the BIS more relevant and useful to the global community, we were relying too much on the views of economists, like myself, with no real training in such organisational matters. As I mentioned to Ethan Kapstein a number of years ago, I thought we needed help and this conference might be the first step down that path.

As to the choice of the **particular topic** for this conference, it was in a way a "no brainer" given that this year marks the 75th anniversary of the founding of the BIS. Since the BIS has been in the central bank cooperation business since its start, the idea of a conference to look back at past successes and failures, and what we could learn from them, had an obvious appeal. Looking forward, there was also a sense that changes in the structure of international financial markets had likely made the issue of international cooperation among central banks of even greater interest than in the past. On the one hand, it could be argued that virtually everything has an international flavour in today's "globalised" world. This might imply even more work for central banks and regulatory agencies to resolve problems of mutual interest. On the other hand, however, with deregulated markets playing a bigger role than ever, and floating exchange rates increasingly the rule, one could also argue that the need for international cooperation has now been much reduced. In a nutshell, if central banks are focussed on domestic price stability, and if domestic financial stability is assured by adequate governance and regulatory standards (albeit likely to be internationally negotiated), what further role is there for international cooperation? Moreover, it could also be posited that the narrower domestic mandate of central banks will further reduce the scope for international central bank cooperation as well.

Before turning briefly to an assessment of past efforts and likely future challenges, it is perhaps worth spending a minute on what is meant by **central bank cooperation**. I think that the terminology developed for domestic monetary policy might have some uses here; namely, the ultimate objectives, the intermediate objectives and the operational instruments. The ultimate objectives have always been monetary and financial stability, though clearly the focus of attention has often shifted over the years. The intermediate objectives of central bank cooperation are more varied. First, better joint decisions, in the relatively rare circumstances where such coordinated action is called for. Second, a clear understanding of the policy issues as they affect central banks. Hopefully, this would reflect common beliefs, but even a clear understanding of differences of views can sometimes be useful. Third, the

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development of robust and effective networks of contacts. Fourth, the efficient international dissemination of both ideas and information that can improve national policymaking. And last, the provision of international credits and joint efforts to influence asset prices (especially gold and foreign exchange) in circumstances where this might be thought useful.

Talking about the instruments of central bank cooperation brings us more directly to the services which the BIS has provided to the international central banking community over the years. First, I would note the various meetings of central bankers and regulators which take place in the “Basel community”, if not necessarily in Basel. These now number over three hundred a year, and involve Governors as well as all types of specialists (IT experts, auditors, security experts, economists, etc.) within the central banks. Second, there is research and policy analysis directed to international issues. This conference is a good example of the genre. Third, there is data and information, most notably on international bank lending, cross border securities markets and derivatives markets. And finally, there are the BIS banking services to central banks which have allowed us to maintain the share of global foreign exchange reserves deposited at the BIS at around 6 percent of the global total. Managing this money gives us a particular insight into how global financial markets actually work.

Well, if that is what central bank cooperation is all about, **has it done any good**? Since I have been in the cooperation business for over twenty years now, the last eleven at the BIS, it would be strange if I did not say yes. The fact that our partners in cooperation keep coming back, in ever increasing numbers and asking for ever more diverse products, also points in the same direction. And, by the standards of other forums for international cooperation, the efforts of central banks also look pretty good. Consider, for example, the issue of collective action clauses in international bond contracts to facilitate agreement among creditors in case of default. These were first suggested by a G10 central bank working group in 1995 (also by Eichengreen and Portes), advocated by the G10 Deputies in 1996, endorsed by the G10 Ministers and Governors in 1997, overtaken by the work of the Willard Group in 1998 and 1999, subsequently forgotten about, and ultimately introduced on a geographically widespread basis only dating from 2003, and only partially in terms of content. Clearly, international cooperation is not always an easy game to play, so even the relatively modest achievements of the central bank community must be viewed positively. And I would like to believe that the contribution of the BIS to this process - a small staff focussed on customer service and the capacity to see two sides of an argument - has also been a useful one.

Yet, for completeness, it must also be noted that central bank cooperation may not always have been used to good effect. Some have argued that the efforts made here in Basel to paper over the cracks in the Bretton Woods system served, not so much to buy needed time, but as a means to postpone needed, and much more fundamental, policy adjustments. My own personal involvement with bridge loans, directed via the BIS to many emerging market countries in the 1980’s and early 1990’s, led me to conclude that some of the later ones should never have been made in the first place. Increasingly, they were show rather than substance and threatened to undermine the credibility of other, more substantial forms of liquidity support.

Looking ahead, a number of **policy challenges** might call for more intensive international cooperation, including among central banks. The first and biggest has to do with widening external imbalances. These could catalyse an international crisis at some point, with potentially disruptive movements in both exchange rates and the prices of financial assets. At the textbook level, it is reasonably clear what all the major players should do to reduce these risks. However, it is equally clear that many of them face other constraints as well, not least political resistance to following the required course of action. In this environment, it does not seem silly to suggest that a cooperative response might be required.

A second challenge for central bank cooperation will be to find ways to better integrate their cooperative efforts with those of regulators and supervisors in the pursuit of international financial stability. Central bankers are increasingly aware that injections of liquidity to support financial stability may lead to excessive increases in asset prices as well as moral hazard. Regulators are also increasingly aware that their domestic efforts also have a macroeconomic dimension. These are conceptual advances. Nevertheless, the cross border aspects of crisis prevention and crisis management need still greater attention. In particular, how a large, complex and globally active financial firm might be wound down, while keeping its vital functions intact, remains a puzzle at best.

And a third challenge has to do with regional central bank cooperation, and how this fits into the broader framework of global cooperation. The BIS was instrumental in helping Europeans prepare themselves for monetary union. Today, similar interests are being expressed in the Gulf, parts of

Africa and Central America. In Asia, a framework for greater monetary cooperation seems gradually to be taking shape, underpinned by increasing trade integration. Everywhere in the emerging markets, there is a keen interest in learning about central banking issues from those more experienced with liberalised economic and financial systems.

To **conclude**, whether looking back or forward, a number of interesting questions pertaining to central bank cooperation remain unanswered. I have every confidence that the presentations and the subsequent discussions will move us a long way towards rectifying that situation. May I take this opportunity to thank all those who have prepared papers, to thank the discussants, and to encourage all members of the audience to participate actively. As I said at the beginning, we all have a lot to learn from each other. So speak up.

Interdependence and cooperation: an endangered pair?

Dinner speech

Tommaso Padoa-Schioppa[1]

1. When I accepted Malcolm's kind invitation to speak here tonight, I thought that preparing for this event would be about the main activity of my first totally free month since the last high school vacation I had in the 1950s. What could be more attractive than reflecting, in the leisurely atmosphere of retirement, on a subject that, over many decades, has occupied both my actions and my thinking?

I was wrong. Retirement is neither a state of quiet nor an instantaneous transition from work to leisure. It is a hectic phase of life in which an aged person is suddenly called upon to deploy the advanced learning skills that only very gifted teenagers have. Such skills are to be applied to high tech activities like booking a low cost flight via the Internet, or informing friends of your new mobile phone number. But it also involves more ambitious and aleatory projects, such as finding a taxi in Rome or reaching agreement in the condominium. The process whereby a badly spoiled child is forced back to normality is morally sound, but occasionally accompanied by the intemperance of the child. In the case of an aged adult, moral soundness is surely greater, but decency forbids any intemperance.

So this gathering has become a welcome opportunity to move from the frantic and complex work of a retiree back to the simple and restful topics that have occupied my professional life.

2. My purpose tonight is to share with you some thoughts on international economic interdependence and cooperation, which I developed through multiple experiences in the fields of central banking and policy making. The gist of such thoughts is the fallacy of the "house in order" precept as an adequate rule to deal with the policy issues raised by economic interdependence. I repeat: "… as an adequate rule to deal with interdependence". I did not say "… as a desirable precept *per se*".

Compared to the general title of the conference, my comments will have a broader scope and a narrower focus. A broader scope because I will refer to "international policy" in general, not to "central banks" only. The intention here is not to avoid being specific about central banks, but rather to place central bank cooperation in the only context in which - I think - it can be properly approached.

The focus will, however, be narrower because I will concentrate on the philosophy, or perhaps the ideology, of interdependence and cooperation, not on its technicalities or its analytics. Cooperation is the word chosen by the organisers of the conference. Coordination is an equally common term used in the literature, which, surprisingly, lacks a rigorous and agreed glossary in this field. To elaborate a taxonomy would be a task in itself, which I shall skip. Just note that I shall use "cooperation" and "coordination" as loosely interchangeable words, meaning the process whereby different policy makers work together for a common purpose.

3. The world in which I was educated and started professional life was strongly marked by a special combination - say, a pair - of economic interdependence and cooperation. The memory was fresh not only of the great world war, but also of the economic evils that had preceded and perhaps facilitated it: the dramatic halt of the long expansion of the 1920s, the rise of nationalism, the collapse of world trade, mass unemployment, financial crises, competitive devaluations.

The acceptance, and even the promotion, of interdependence was seen as a way to prosperity and as an antidote to aggressive policies. There was a bias in favour of international cooperation, because

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this was seen as an economic corollary, or perhaps rather a lemma, of interdependence, a key foundation of a world freed from past grief.

It is remarkable that for many years no significant voice, from political or academic society, questioned either term of the pair or their juxtaposition. Politically and intellectually such questioning would have appeared as incorrect, because the cooperation bias was so strong.

4. From this point of departure - fixed by the experience of the 1930s and 1940s - the market and the policy components of the pair moved in rather different ways. Interdependence galloped, cooperation slogged. The strong pro cooperation attitude gradually faded, while a different mindset gained ground.

Consider interdependence. The first striking trend was its phenomenal *deepening*. The fact that decade after decade international trade grew at about twice the rate of growth of world GDP is the most visible indicator of this trend. As Adam Smith discovered and elementary textbooks have taught ever since, division of labour made people and nations at the same time less self-sufficient, more mutually dependent and richer. The *widening* of interdependence, however, was not less striking. It was a *geographical* widening, as the number of active participants in the global division of labour increased to the point of including almost every country of the planet. But it was also an *economic* - or functional - widening, as cross border mobility and exchanges extended from the original fields of finished goods and raw materials to intermediate goods, services, capital and labour. All in all it is not an exaggeration to say that today interdependence *across* nations is far greater than interdependence *within* nations was two or three generations ago.

Consider now cooperation. “Slogging” may sound like a harsh and undeserved word and let me say immediately that I presume to fully acknowledge - and even to have occasionally contributed to - some remarkable progress in international cooperation over the last three decades. Membership in international organisations, institutions and forums (be they the IMF, the World Bank, or the OECD, not to mention the BIS itself) grew in line with the geographical widening of interdependence. New forums such as the BCBS, the CPSS and the FSF were created. The agenda of cooperation widened to include fields like banking supervision, securities regulation, or payment systems, which were previously the preserve of national authorities.

Still, there are good reasons, in my view, to maintain my choice of words. The inevitable collapse of the Bretton Woods regime deprived the international system of a strong and accepted mechanism to impose adjustment of imbalances. The ideology of unrestricted national sovereignty made a powerful comeback. Most of all, cooperation did not progress at the same phenomenal pace at which interdependence did. The gap between needs and accomplishments actually widened.

5. Given this, I would like to discuss the intellectual argument underpinning what I have called the “slogging” of cooperation.

To be sure, the key reason for the slogging is not an intellectual argument, but rather a hard fact; the fact that an increase in *policy cooperation* faces formidable obstacles that do not exist for *economic integration*. The two terms of the pair - interdependence and cooperation - are indeed driven by different agents, subject to different constraints, and moved by different aims. Interdependence is driven by the self-interest of firms and households, which maximise utility functions with no regard for political borders. There is no equivalent self-interest for the actors of policy cooperation, which are mainly entrusted with the task of pursuing a national interest, directly elected by the citizens or accountable to elected bodies. This fundamental asymmetry explains the different speeds at which the two terms have evolved.

These are facts. But the influence of ideas should not be underestimated. And a conference of academics and policy makers is the right venue to exchange intellectual arguments.

The intellectual argument developed by policy makers and scholars to provide a rationalisation of the widening of the gap can be put under the general name of “house in order doctrine”.

The house in order doctrine states that if each and every national policy player kept its house in order, then the world itself would be in order. In this case there is no special need for policy cooperation or coordination, no need for any prior commitment to act together, no need for collective decisions resulting from a policy give-and-take. At most, what is needed in addition to good housekeeping is a regular exchange of information.

The doctrine is not formulated in the literature in the way I have stated it, but rather popularised by economists and policy makers. It is a collection of arguments, rather than a single economic theorem.

Yet it can often be encountered in policy documents of national and international institutions as well as in the non-technical writings of prominent economists.

Moreover, the doctrine claims powerful academic credentials. So, let me now turn to such claims and briefly examine the two main ones.

6. The first claim of the house in order doctrine is to be the legitimate heir of the tradition of economic liberalism. Already John Stuart Mill had argued that "it is in general a necessary condition of free institutions that the boundaries of governments should coincide in the main with those of nationalities". And the *Zollverein* advocated by Friedrich List was internally market oriented and externally protectionist.

Later, in the mid-20th century, the main argument against international policy coordination was that this would create an international leviathan increasing government intervention.

This argument, however, does not stand against the compelling theoretical argumentation of leading liberal thinkers and is inconsistent with the lesson of history. As to theoretical thinking, such eminent liberal economists as Hayek, Einaudi and Robbins had conclusively demonstrated the difference between the decision on how activist the state should be in economic policy and the allocation of power across different levels of government. On the first, they favour strong limits to public intervention, but on the second, they espouse the creation of an international level of government for its peacekeeping and wealth-generating impact.

With the swing in the pendulum of ideas and policies away from activism, two pairs of attitudes have been arbitrarily formed: government intervention cum international cooperation, on the one side; market orientation cum national egoism on the other. It has been wrongly argued by Friedman and his followers that rejecting the form of policy activism that was dubbed "Keynesianism" needed to automatically entail opposition to the cooperative spirit that characterised the post-World War II years. In reality, describing international cooperation as an exclusive feature of an interventionist state is a major conceptual mistake. It confuses the sphere of economics with the sphere of politics. To combine the concept of the minimal state with that of a strong, and yet limited, supranational level of government is certainly more congenial to the legacy of liberal thinking than to any other economic or political doctrine. Such a government should be imbued with the power to enforce free trade, openness of economic frontiers, non-discrimination and the international rule of law.

As to history, it would be wrong to attribute the collapse of the pre-1914 world to the rise of illiberal domestic policies. At the time, the role of the state in economic and social policies was still minimal. And even before liberal economic policies deteriorated, the foreign policies of the nation states had taken a turn towards militarism. Already in the mid-19th century, a split had emerged between liberal domestic policies and an aggressive foreign policy. In the period before 1914, very little was left of the combination of political, economic and cultural elements of the golden years of the 19th century. The shot of a pistol was sufficient to make the edifice crumble. World War I was the effect of the unsustainability of the preceding order, not the cause of its fall.

7. The second claim of the house in order doctrine is to be the robust discovery of recent economic research, supporting the proposition that international policy cooperation is not desirable and may be counterproductive.

Scrutiny of this recent literature is somewhat awkward for a policy maker, not regularly frequenting the research laboratory and, at best, only familiar with penultimate generation analytical tools. The body of the literature is large and still growing, often analytically sophisticated and difficult to read. Yet, let me state in simple terms the three reasons why the recommendation to refrain from structured international policy coordination looks ill conceived to me.

The first reason is that the scholarly debate is far from concluded. It is in the typical phase in which different results are collected presenting different conclusions, which are strictly dependent on the chosen assumptions. There is no "general theory" for the time being. For every paper advising against cooperation there is another paper recommending it.

The second and far more important reason is that the debate is, by construction, somehow off the mark. Indeed, most of the literature explores circumstances in which cooperation produces a better or an inferior outcome compared to the result produced by "going it alone". One is tempted to ask: "and so what?". What is the ultimate value of this collection of examples? The optimal policy *line* and the optimal policy *level* must not be confused and require different types of investigation. I wonder if this literature is not simply discovering the obvious, i.e. that a policy maker or a government can make mistakes? But is this a reason to do without it? Is the fact that the US Fed presumably made policy mistakes in the 1930s a good argument to conclude that a central bank should not have been created?

The third and related reason is the failure to rigorously define the non-coordination regime. Often, the anti-cooperation authors loosely speak of policy competition as the alternative. Of course, "competition" sounds better than "conflict". But how to draw the line which separates the two? What we know is that the distinction is exceedingly difficult and controversial both analytically and practically. What we also know, however, is that competition, unlike conflict, requires a strong framework of agreed and enforceable rules. And how could this strong framework come into existence if not through an extraordinary cooperative effort by the would-be competitors?

My impression is that the scholar sometimes forgets to strip down his ideological conviction and leave it at the door before entering the laboratory. And let me say that it is somewhat amazing to see authors like Rogoff using completely different linguistic and analytical precautions in the "pop" and in the "lab" versions of their thinking. One may ask: which of the two inspires the other?

8. Let me conclude. Policy making consists, by definition, in pursuing the public interest. But what does "public" mean? It may mean different things for different communities and if the optimum government is to be neither below nor above the level at which an interest needs to be recognised as public, then a multi-tier government is necessary. The choice of the appropriate level relates to the definition of the area in which a good is in fact public, i.e. whether it is a local public good or whether, at the other extreme, it is a world public good.

As interdependence broadens and deepens so does the "public" domain, because the economic and the political order are fundamentally interlinked. Here is the sense of the pair. Policy coordination is the way to deal with this broadening and deepening in a world in which political borders exist and the nation state preserves the largest portion of public power. Inevitably, cooperation among national public actors entails a reduction in the independent decision making power of national institutions.

The reluctance to confer portions of the national power to international forums and institutions is based on a model of sovereignty according to which government should remain undivided, be kept as a single and monolithic block. This model originated with the Westphalian order, took strength from the Jacobin movement during the French Revolution and was increasingly engrafted in the course of the 19th century, first with the idea that nation and state should coincide, then with the rise of representative government and the advent of universal suffrage. But it was this same evolution that set the conditions for the rise of nationalism and the catastrophe of 1914-45.

While the memory was still fresh, the lessons from history and politics impregnated the thinking of economists and the attitudes of policy makers; hence the balance on which the pair was set in shaping the post-World War II world. As time passes, however, memories grow dim and the risk augments that the pair will shift off balance.

Just as politicians, according to Keynes, are the slaves of some defunct economist, so economists and officials tend to be the slaves of some defunct historian or political thinker. They risk neglecting the fact that in a globalised world unlimited national autonomy does not exist any longer and that sovereignty can in fact be regained - rather than lost - when delegating tasks to supranational forums and institutions. As Robert Cooper puts it in his recent *The Breaking of Nations*: "For the post-modern state, sovereignty is a seat at the table".

Reflections on the future of central bank cooperation

A D Crockett[1]

This conference has been a fascinating opportunity to step back and consider how central bank cooperation has worked in the past, and how it might develop in the future. We have heard both from practitioners and from informed outside observers. We have discussed the processes for cooperation as well as some of the substantive issues that confront economic policy makers. And we have been able to look at central bank cooperation, not only from the perspective of central bankers and monetary economists, but also from that of those in other disciplines, who bring different insights to bear.

In these closing reflections, I will briefly refer to four issues of process, and four substantive topics for cooperation that have come up during the past two days.

Processes for cooperation

1. Intensity of cooperation

The question of the *intensity of cooperation* arose in a number of guises. Some referred to continuous versus episodic cooperation; others to low-level versus high-profile cooperation; while others spoke of coordination versus information sharing; and still others of "hard" versus "soft" cooperation.

It seems clear that central bankers attach value to continuous low-profile exchanges of views, such as those that occur at the bimonthly meetings here in Basel. Recent trends show no diminution in this interest (rather the reverse) so there is every reason to expect this form of consultation to continue in the future. This yields two distinct benefits. It enables policy makers to "step back" on a regular basis and test their perceptions of economic and financial trends against those of their peers from other countries. And, as Richard Cooper pointed out, it permits a form of "bonding" among central bankers that can facilitate more intense collaboration in times of stress.

Regular, low-profile meetings between central banks have more mundane benefits as well. Since each central bank is a unique institution in its own country, it has no possibilities to benchmark performance or to learn from the experience of comparable institutions within its own territory. Meetings with other central banks, as we have heard, enable all participants to become more rapidly aware of new techniques and approaches, and to share views on their effectiveness. This applies not just to major policy trends (such as the development of inflation targeting in the 1990s) but also to day to day responsibilities, such as bank note printing, branch management, recruitment and personnel issues, market management techniques, legal issues and so on.

2. Regional versus global arrangements

A rather different topic is the evolution of cooperation among central banks on a *regional basis*. The BIS began as a primarily European (and later G10) organization, which has in the past ten years successfully evolved into a global instrument of cooperation. A consequence of its success is that more central banks want to participate in its activities than is consistent with the informal "club" atmosphere that the original members find most conducive to informal and meaningful discussions.

[1] President, JP Morgan Chase International, former General Manager of the BIS.

Over the past decade or so, regional groupings, many of which have been in existence for quite some time, have begun to play a more prominent role in regional central bank cooperation. These include SEACEN, SEANZA and EMEAP in Asia and CEMLA in Latin America, as well as other forums in which central banks cooperate along with other economic policy makers.

An important challenge for the future will be to find the right *modus vivendi* between global institutional mechanisms, such as the BIS, and the regional groupings. It is my belief that these groupings will continue to play a highly constructive role. Many economic issues, especially with regard to exchange rates and financial stability, arise in a regional context; and anyway, the scope for continuous interchange of ideas is greater where distance and time zone obstacles do not apply. So I believe that there will continue to be refinement of the model under which central bankers of the major countries continue to meet regularly in Basel (and hopefully elsewhere from time to time) while regional arrangements flourish and their ties are strengthened through the development of a global network.

3. Role of the private sector

Another topic that I believe is of growing interest is the appropriate *involvement of the private sector* in discussions of central banking topics. Clearly, it would be inappropriate and unrealistic to involve private sector representatives in monetary policy discussions. However, since policy works *through* the responses of private economic agents, it is important to have the best possible information on what shapes these reactions. Moreover, when it comes to formulating rules for banking regulation and supervision, it seems clear that effective consultation mechanisms with the institutions directly affected need to be in place.

The BIS has already taken steps down this road. For some time, the Basel Committee has been consulting the private sector, and others, on new banking rules. This process has been considerably stepped up under Basel II. Also in the area of economic trends more generally, the BIS has initiated regular low-key meetings with CEOs and CFOs of major financial institutions. An intensification of these public-private sector contacts could be of value in creating greater mutual understanding.

4. Transparency and governance

Several speakers referred during the conference to the growing desire for *transparency and accountability* from governments and international institutions. This will pose a challenge to central banks and their traditional methods of cooperation. Governors have always seen the attraction of their low-key cooperative methods in the fact that they could have informal discussions, without the need to think about communiqués or press conferences. They have valued a frank exchange of views, which is fostered by a confidential atmosphere.

The challenge is to preserve what is good and necessary in current confidentiality arrangements, while satisfying outside desires to be informed about what is going on, and in particular avoiding suspicions that an unelected group is making secret decisions affecting global welfare, without being held accountable. I do not have an answer to this dilemma, but I believe it is vitally important to find a way to convince skeptical outsiders that confidential exchanges of views, which all central bankers regard as vital to the effective performance of their mandates, are not contrary to broader principles of openness and accountability.

Substantive topics for cooperation

1. Monetary policy and price stability

The primary duty of central banks is the achievement and maintenance of price stability. At first sight, it might appear that this objective offers limited scope for international central bank cooperation. Each country needs to do what is necessary to achieve price stability within its own borders, and “bargains” between central banks would be unlikely to play a constructive role. This is the “house in order” principle referred to by Tommaso Padoa-Schioppa in his keynote address at the outset of the conference.

But while formal coordination (ie joint decision making) is unlikely to be adopted, there are many contributions that informal international discussions can make. First, having a better understanding of the likely policy responses of central banks in other countries can improve policy makers' understanding of the context in which they will have to shape their own policies. Second, hearing the analysis and justification used by other central bankers in reaching policy judgments can provide new insights for interpreting issues that arise in a given domestic context. Third, sharing approaches to the public *presentation* of policy can help in the constant task of explaining central bank objectives. Finally, and most generally, regular meetings of central bankers foster mutual moral support for price stability objectives. It can be lonely pursuing necessary but unpopular policies. I don't think it is a complete coincidence that the battle against inflation was successfully waged by a large number of central banks at the same time.

2. Exchange rates

Exchange rate policies and intervention arrangements were the fields in which central bank cooperation became most developed in the early postwar decades. Now, however, it seems unlikely that concerted intervention, or exchange rate targets, will play a significant role among major central banks in the foreseeable future.

This does not mean that exchange rate developments will no longer be topics of concern to central bankers. In the first place, the exchange rate is a very important price in any economy, and even if policy makers do not seek to influence that price, they certainly have to factor it into their monetary policy decisions.

But perhaps more significantly, there could well be a revival of the view that exchange rate stability is, by itself, desirable, and that some shading of other policies to reduce exchange rate volatility is justifiable. In saying this, I am thinking in particular of Asian economies. Trade within Asia has been helped by the relative stability of intra-Asian exchange rates, which in turn has been facilitated by pegging to, or informally shadowing, the US dollar. It is unlikely that dollar pegging will continue indefinitely, and when it ends, Asian countries will want to have in place arrangements that help limit damaging fluctuations in exchange rates. I am *not* suggesting a formal mechanism, rather an intensification of consultative arrangements, in the context of mutual recognition of common interest in exchange rate stability.

3. Banking regulation

The Basel Committee on Banking Supervision has been among the most successful manifestations of central bank cooperation in recent years. The need for an international approach to banking supervisory rules is unlikely to go away. However, the specific role of central banks has been changing and will probably continue to change. This is largely due to the fact that responsibility for supervision has been gradually moving away to independent supervisory authorities, a trend unlikely to be reversed.

However, central banks retain a responsibility for systemic stability, either in statute or at least in the public perception. How to reconcile central banks' overall responsibilities for the health of the financial system with the specific supervisory responsibilities of independent regulatory authorities will, I believe, be a theme of debate for many years to come.

I personally hope it will be possible to build on the infrastructure developed at the BIS to strengthen this process. The Basel Committee, the International Association of Insurance Supervisors and the International Association of Deposit Insurers already operate under the auspices of the BIS, but with largely complete substantive autonomy. Would it be possible to bring all relevant international supervisory groupings under the same roof, in a way that respects their institutional autonomy, while exploiting the synergies of a common location, and the ability to discuss and resolve issues of common concern? There are many institutional rivalries to be overcome to make this vision a reality, but I think the advantages would be substantial. My proposal is something well short of the "World Financial Authority" advocated by some, but is still a major step in the direction of strengthening cooperation among relevant players.

4. Managing financial crises

When most people think of international financial cooperation, they often think of the management of financial crises. As I have argued above, that is not the only, or even the main, manifestation of cooperation, but it is still an important one.

Since the management of crises involves the actual or potential commitment of public money, unelected central bankers will never play the leading role. But that does not mean they will not play important advisory roles, openly or behind the scenes. In a crisis, there is often a temptation for politicians to take short-term palliative measures, without full regard for the longer-term consequences on market functioning and private incentives. Central bankers, due to their particular responsibilities, are better placed to take a long-term view. Cooperation among central banks may mean developing a collective view of the systemic consequences of different means of dealing with crises, then conveying this view to finance ministry colleagues.

Of course, there are financial roles that central banks may also be called on to play, such as in the provision of bridge finance to stave off particular dangers. In this, the market knowledge and ingenuity of central banks can be of immense value, even if the ultimate political decision to commit public funds is taken elsewhere.

Reflections on the future of cooperation between central banks

J de Larosière[1]

In a world which is financially globalized but where economic policies are independently decided by individual nations, what is the scope for cooperation between Central Banks?

Such cooperation cannot resolve by itself the problem of a worldwide optimal "policy mix". No more than in the past. Indeed, governments remain responsible for their own economic, fiscal and structural policies. Each Central Bank has thus to "navigate" in order to achieve its objectives as regards price stability. By definition, this navigation remains separate and difficult to coordinate.

But financial globalization makes cooperation between Central Banks and regulators all the more important. This cooperation has achieved well known results. I shall mention three examples:

1. The banking regulation concerning capital adequacy ratios. We know that the international agreement reached in 1987 (the "Cooke ratio") has profoundly transformed the way banks operate (until then, they had practically unlimited freedom within the framework of their national standards) and powerfully contributed to the strengthening and the consistency of the international financial system. Basel II, crowning years of hard work and negotiations, is about to be implemented and opens a new chapter in the history of financial institutions. This enormous effort of rationalization, harmonization and modernization as regards risk evaluation and provisioning is to the credit of the organization that has been the real "melting pot" of Central Bank cooperation, namely the Basel Committee.

2. I would also like to mention, although the example is less recent, the cooperation between Central Banks as regards financial crises. The way the BIS - and thus the member Central Banks - contributed to the success of the restructuring of emerging market countries' sovereign debt - notably in Latin America during the 1980s - is certainly worth mentioning. So is the role played by the Federal Reserve Bank of New York at the time of the LTCM crisis some years ago. I wish personally that Central Banks would get more involved in the implementation of the "Principles" adopted in December 2004 by both issuers and private creditors as regards the prevention of debt crises and the restructuring of emerging market sovereign debt.

3. In a more general way, Central Banks have played - largely through their common approach fostered by their bimonthly meetings in Basel - an essential role in the formation of an anti-inflationary consensus since the beginning of the 1980s. The fact that almost all Central Banks obtained their independence from governments during the last two decades and that they have adopted inflation targets, in one form or another, is a result of such common understanding.

* * *

But what could be the scope of Central Bank cooperation for the future?

1. The field which I mentioned first - i.e. cooperation between banking regulators - will remain. Even if, over the last ten years or so, certain Central Banks have lost their power as regards bank supervision - responsibility for which has been, in some cases, extended to all financial institutions and entrusted to enlarged and separate entities - cooperation between Central Bankers will continue to be essential.

Indeed, with the elimination of financial borders, the development of new and always more complex products based on derivatives which are offered more and more widely to investors, the growing interconnexions between cross-border financial intermediaries, and the enormous and ever increasing scale of electronic settlements through payment systems are not factors that reduce systemic risks but, on the contrary, can increase them. The chain of transactions is long and involves a multitude of

[1] Former Managing Director of the International Monetary Fund, former Governor of the Bank of France; former President of the European Bank for Reconstruction and Development.

players. The breaking of a link of this chain can entail contagious reactions of which we have already seen some examples in the past.

And this is where the problem of the lender of last resort comes up. This has always been a touchy issue, but it becomes more difficult still in a world without borders. As the old saying goes: “Never speak about it publicly but always think of it”. This responsibility will remain one of the most important tasks for the Central Banks of tomorrow, and Central Bank cooperation in this field will become more and more essential, although governments can also be - and will be - involved in insolvency crises.

In this respect, the agreement of May 18 2005 on a Memorandum of Understanding between banking supervisors, central bankers and finance ministers of the European Union on dealing with crisis situations is a reminder of the importance of this issue. The MOU is a way of enhancing practical arrangements concerning cooperation in cross-border crisis situations at the EU level.

2. The world is globalizing but it is also tending to concentrate in more and more closely knit geographic zones. This is already the case in Europe. The creation of the euro in 1999 has changed the conditions of cooperation between the Central Banks of the euro area. These institutions have established a “European System of Central Banks” and participate in the decision making and in the implementation of a single monetary policy. This system is about to take in new members from Central Europe.

Euro area Central Banks continue to hold some responsibilities separately, in certain fields like - for some of them - bank supervision, risk monitoring, the functioning of payment systems. But they are becoming actively bound in more and more narrow processes of cooperation.

The question is whether other monetary areas will emerge in the future and, if so, which will be the operating mode of cooperation of the concerned Central Banks, both between themselves and towards the rest of the world. The developments we are watching in East Asia concerning financial cooperation (CMI swap arrangements between Central Banks, Asian bond initiatives, etc.) could be the harbinger of further, deeper monetary integration.

3. Finally, there is the broader issue of the future of worldwide monetary cooperation.

This cooperation, channelled through the G10 and G7, has worked up to now within the limits imposed by the national interests pursued by each member state. Rarely have Governments or Central Banks agreed to change their own policies just to adhere to cooperative objectives (with the exception of EMU). But policy recommendations were formulated and, in rare cases, followed. Were these recommendations always right? It is difficult to give a simple answer. But one can have doubts (i.e. the pressure exerted on Japan in the 1980s to reflate its monetary policy contributed, eventually, to the bubble and to the arduous and costly correction thereafter).

So what about macro-cooperation in a world where the current account deficits of the US have reached record levels and are a threat to the stability of the system, where exchange regimes are, in many cases, chosen “à la carte”, where protectionist risks are always present and where the distribution of monetary assets held by Central Banks is changing dramatically?[2]

Will there be a real - and institutionalized - integration of China (set to be a dominant player in the years to come) and other Asian countries whose currencies are de facto pegged to the US dollar, while their annual current account surpluses represent some $300 billion? Will the IMF assume responsibility for firm currency surveillance and prevention of misalignments?

Will the IMF play a central role in achieving integration? Will the present players be farsighted enough to open up to China and bring it into their inner multilateral circle?

Those are some of the questions that will dominate the issue of cooperation between governments and monetary authorities in the years to come. The earlier they are addressed in the framework of a credible IMF - seen to be and acting as the guardian of the system - the more we should be able to avoid a “disintegration” of a multilateral cooperative system which, on the whole, has served the world well since the end of the Second World War. But, as Tommaso Padoa-Schioppa said at this conference, cooperation is far from intensifying at the same speed as the interdependence of the world economy.

[2] In 2000, 43% of total world reserves were held by the Central Banks of industrial nations. Total reserves have doubled in the last four years. Today, the so-called “emerging” countries hold almost 2/3 of the total ($2.4 trillion out of a total of $3.7 trillion).

Policy cooperation

Allan H Meltzer[1]

The subject of this panel, policy cooperation, has several meanings. When I became chairman of the International Financial Institution Advisory Commission, two people who were well acquainted with the Bank for International Settlements advised me separately that the Bank played an important role, one that they valued highly, in promoting understanding and, at times, cooperation. Since I respect and admire Hans Tietmeyer and Alan Greenspan, I accepted their view that the regular meetings of central bankers at this Bank promoted understanding of the political constraints under which some central banks operated and encouraged cooperation. This is one, useful, but relatively narrow meaning of central bank policy cooperation.

A second, and to me less appealing meaning takes the form of exchange rate coordination, whereby countries agree to adjust their nominal exchange rates by changing domestic policies. Examples include the 1936 Tripartite Agreement between Britain, France, and the United States or the efforts in the 1970s to convince Germany to expand more rapidly to help the United States. Proposals of this kind often require actions that are opposite to the policy actions countries would choose in the absence of coordination. For example, during the late 1970s, the United States wanted Germany to inflate somewhat faster to prevent nominal dollar depreciation. The German response was, in effect, that the same result could be achieved by less inflation in the United States. Coordination of this kind often fails.

A third kind of policy coordination is the topic I want to address. I propose coordination by the United States and Asian and European countries to deal with the growing imbalances in the world economy. The proposal I offer asks countries to agree to policies that are in their own long-run interest but also each other's. Political concerns in each country keep them from adopting these policies unilaterally. Mutual agreement - coordination - may be a way of breaking the stalemate.

There are at least two views about current imbalances. A large number of studies by Mann (1999), Obstfeld and Rogoff (2004), Truman (2005), Roubini and Setser (2004) and others argue that the U.S. current account deficit is "unsustainable." They produce evidence from econometric models showing that the U.S. current account deficit will rise to 8, 10, or even 12 percent of U.S. GDP. One can cite Herbert Stein's dictum that unsustainable trends end. The question is: how do they end? Most of these authors respond that they end with a crisis, a collapse of the dollar, and perhaps even a world financial and economic crisis.

Let me interject that I do not find these arguments appealing and that, more relevantly, long-term interest rates and expected exchange rates show no evidence that markets attach much weight to these forecasts. Even less appealing is the frequent conclusion that the United States should act now, unilaterally, to curtail domestic demand and increase national saving. There are three reasons for my reaction to this conclusion.

First, I do not believe the casual argument that a smaller reduction in U.S. aggregate demand now should be preferred to an uncertain larger reduction later. Perhaps. Perhaps not. Both the future and the predictions of crisis are too uncertain to accept that claim.

Second, and most important, some policy simulations that the authors produce suggest that to achieve a 20 percent devaluation of the nominal dollar exchange rate, with Asian exchange rates pegged to the dollar, an 84 percent appreciation of the euro would be required, a change to about 2.25 dollars to 1 euro. With 20 percent appreciation in Asia, the euro reaches about 1.85 dollars to 1 euro and the yen appreciates to 85 yen to the dollar (Truman (2005, Table 5)). These are very large appreciations for relatively slow growing economies, and, in the case of Germany and Japan, economies dependent currently on export growth.

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[1] University Professor of Political Economy, Carnegie Mellon University and Visiting Scholar, the American Enterprise Institute.

Third, most proposals for unilateral action by China or the United States seek one-time adjustments in the U.S. current account as a percent of GDP. They do not ask whether, after the adjustment, China's growth rate would be high enough relative to the U.S. that the problem would return at the new exchange rate for the renminbi. If they are right about a coming crisis, and I am skeptical, they should seek a permanent or sustainable solution.

There is another side. Many writers suggest either that the problem is likely to be solved in an orderly way or that the current account deficits are sustainable. There are many variants of this view that I associate with Alan Greenspan (2003), Ben Bernanke (2005), Richard Cooper (2004), Alan Stockman (2005), and Michael Bordo (2005).

The simplest argument, and one that I have made elsewhere, is that much of the world and especially China are modern mercantilists. To create employment China undervalues its currency to promote its exports. Some estimates suggest that China has 150 million workers unemployed or underemployed. For comparison, that is more than the entire U.S. labor force. China willingly subsidizes exports by as much as 1 or 2 percent of its GDP. The rest of the world, especially the U.S., gets consumer goods and inputs for its domestic production in exchange for pieces of paper that are costless to produce. Why complain?

The main concern is, again, that the system is unsustainable. Critics could not imagine that China would want to hold $600 billion or more in dollar assets. Double or triple that amount strains credibility past the breaking point. Perhaps they are right. But perhaps China values employment of the 150 million more than the possible loss from holding enormous reserves.

A second concern is less often advanced. The arrangement leaves the U.S. economy undercapitalized and the Chinese economy overcapitalized. In effect, China builds the capital stock to produce the goods that the U.S. and others consume. At some point that will change, with possible business cycle type consequences.

Third, there are transitional and possible permanent costs. For example, workers in the importing countries lose jobs. The United States is close to full employment, but many of the new jobs are said to have lower pay or fewer benefits. And in Europe, the unemployment rate remains high. Imports are by no means the principal or only reason for this, but they are a visible and politically potent reason.

One result of this situation is political pressure to restrict imports. It is not enough to point out that this is short-sighted or that freer trade since World War II has raised living standards for more people, in more countries, by larger amounts than in any previous period. That is unlikely to stop the pressure for new trade barriers.

At one time, I thought that China's surplus at a fixed exchange rate would inflate the currency and raise Chinese prices. Instead, depreciation of the dollar and a pegged exchange rate produced a depreciation of China's real exchange rate. Although China has experienced some inflation in the past two years, the combination of exchange controls and capital controls has hindered adjustment.

What to do?

The studies cited earlier and many others suggest that, taken separately, revaluation of the renminbi, increases in a U.S. national saving rate, or other unilateral actions of reasonable size would not yield a permanent solution.

A multilateral solution should therefore be developed. There is a need for policy coordination to obtain a solution that overcomes political blockages in each region and induces actions that are beneficial to each of the countries or regions involved. I side with those who believe a crisis is unlikely, but a prudent person should not ignore the risk posed by current imbalances and policies.

The component parts of a multilateral solution are well known. The United States has to increase its national saving rate. China and other Asian countries have to reform their financial sectors and allow exchange rates to adjust. Large European economies and Japan have to make structural changes that reduce unemployment and increase world demand. Those adjustments are beneficial in the long run to the countries that make them. The problem is to overcome the political impediments to a solution that is of benefit to each of the participants but difficult to arrive at unilaterally. Hence there is a role for coordination.

I have no illusion that coordination can be achieved easily. The IMF and the BIS should accept responsibility for beginning the negotiation process. Negotiations may be slow to achieve agreement and, of course, they may fail. However, that is never a reason for not starting.

Under its rules, the IMF has responsibility for the exchange rate system and for preventing countries from using an undervalued exchange rate to promote domestic employment objectives. Current policies in many Asian countries surely call for more effort by the IMF to enforce this rule. On the other hand, Asian countries are surely correct when they claim that the U.S. national saving rate is a cause of imbalances. And U.S. policymakers are correct when they claim that slow growth in Europe and Japan are part of the problem. Each is correct. That's why a multilateral solution to put the world economy on a more stable path is both desirable and probably necessary.

The BIS has a smaller, but still significant role. Current imbalances are not solely monetary problems, although fixed Asian exchange rates are an important part of the problem. A main role of the BIS is to begin discussion by central bankers on a multilateral solution and to encourage central bankers to use their influence to get governments to reach agreement.

Let me close by mentioning a possible side effect of adjusting the renminbi to reflect its market value. China has used revenues provided by its rapid growth to finance a large armaments program. Unless the entire effect of slower growth were to be borne by domestic consumption and productive investment, this military build up would slow. This would benefit Asia and the rest of the world.

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Comments

Paul Volcker[1]

Mr Chairman, Ladies and Gentlemen, given the time and as it is not easy to say something fresh at this stage in the programme, let me try to concentrate on just a few points. First, however, I cannot help but say that I feel somehow a little ghostly at this place. I haven't been at the BIS for 15 or 20 years and I wonder: where is Jelle Zijlstra, where is Otmar Emminger, where are Guido Carli, and Rinaldo Ossola, and René Larre, and Fritz Leutwiler? They are all gone. The only people I know in the international monetary arena now are sitting up here in the panel along with one or two more in the audience - like Alexandre Lamfalussy or Ted Truman.

I would like to give you a very quick review of the lengthy time I have spent in this area and the first point I would make is that - as we talk about and even glorify central bank cooperation and independence - we should not lose sight of the fact that, if we want to achieve international monetary cooperation, governments will have something to say about it. Inevitably, it is not a matter for central banks alone. You will not have an exchange rate regime without the government approving it. You will not have, most of the time, intervention, to the extent that it is relevant, without governments approving sooner or later because you are dealing with public money. You certainly, in my experience, will not have rescue operations without finance ministries and governments being involved. In the old days, I was greatly in favour of a primary role for central banks in banking supervision and regulation - but even that today is hardly a province we can claim for central banks alone. So let me just make the point that, when we talk about international monetary cooperation, we have to talk about more than central banks.

Now let us take a look back at the Bretton Woods era. In fact, I do not think much happened in terms of international monetary cooperation in the 1950s - the days of dollar shortage, the Marshall Plan and all that. In the 1950s, I can tell you, there was not much experience in the United States government with international monetary affairs in the way we think of it now. The same held for the academic world too. When people taught economics in the United States, the last chapter in the book was international monetary affairs and there was always too little time to get to the last chapter, so it was never much taught.

Now that changed, obviously, in the 1960s, but when I initially got involved in international monetary cooperation I happened to be with the Treasury, not the central bank. The point I would make, looking back - and which I do not think is true today - is that there was a sense of dedication to the particular system that existed at that time, the so-called Bretton Woods system. There was a strong instinct on the side even of the United States, and certainly on that of European countries - while Japan and the rest of the world were still somehow out of the loop - to rally to the defence of Bretton Woods and of exchange rates. It was almost treasonous in the US Treasury - I can assure you that it was certainly a cause for immediate removal from office - if you raised any question about the gold/dollar link or the exchange rate of the US dollar.

Against that background it was really a remarkably fruitful period for innovation. I am referring to some of the things that have been mentioned before - the IMF's general arrangements to borrow, the swap network, the Roosa bonds, repeated rescue operations, occasional intervention, the gold pool, the two-tier gold market - all in the space of less than a decade. This also included controls on the flow of capital - we did not call them exchange controls - even by the United States; all in an effort to maintain the existing system. I think it was quite successful for quite a while. Economies were doing well. But of course the basic system broke down and none of these particular patches could work indefinitely against the pressures that arose with the opening of the capital markets and differences in economic development. Now, people were certainly not oblivious to that. The Special Drawing Rights (SDRs)

[1] Former Chairman of the Board of Governors of the US Federal Reserve System.

were created to try to settle some of the systemic problems; but the system broke down nonetheless, and I must add that at the time the breakdown was not handled in the best possible way.

The 1970s was not a bright decade for international cooperation. There was enormous instability in exchange rates and I think the breakdown of the system was not entirely unrelated to the fact that this was a decade of stagflation, increasing inflation. There were attempts at coordination: there was an attempt at policy coordination in 1978 when the dollar came under great pressure; there were occasional monetary policy changes that were coordinated well into the 1980s. To deal with extreme exchange rate volatility, there was the Plaza Agreement (1985) and the Louvre Agreement (1987). In my view Plaza was never necessary because the exchange rate was going south anyway so far as the US dollar was concerned, and the Louvre Accord was far too ambitious. As it turned out, neither of those in the end were great victories for coordination, but they were worthwhile attempts all the same. I think that, at least in the case of the Louvre Agreement, part of the value was that it highlighted the US failure to react to pressures on the exchange rate. If the US Administration had been more sensitive to the exchange rate problem, I believe that this would have been to the benefit of American domestic policy, as was so often the case. In any event, what followed was that European policymakers could not live with the persistent exchange rate volatility, and worked out their own answer - they effectively eliminated volatility in Europe by eliminating individual currencies. This, of course, required a very high degree of coordination and cooperation, also in policy terms, but otherwise macro-coordination was not very active or successful.

Now, in spite of that, as has already been mentioned, there was *very* strong cooperation among central banks, in support of their governments and the IMF, in dealing with the 1980s debt crisis. Looking back, many people argue that the 1980s was a lost decade for Latin America. The fact is, though - and this is sometimes forgotten - that the debt crisis was a threat to the international financial system. The big banks in the United States and some of the European banks were committed to Latin American bonds in amounts in excess of their total capital position. As a result, a major thrust of dealing with that crisis was to protect the integrity of the banking system in the United States and elsewhere and I think it met with some success. This was essentially a central bank-IMF initiative that, in my view, was a bright spot of cooperation. It was certainly a strong reminder to us and to others that the large international banks generally were not sufficiently capitalised. In fact there were those who had recognised this earlier - for instance in France. France’s bank capitalisation ratios looked almost heroic compared to Japan, but at that point we were also quite worried about American banks. As a result, the whole Basel I exercise was inaugurated, and for all the deficiencies of that approach and in the face of increased market sophistication, the major objective, namely to improve the capitalisation of the banking system, was successfully achieved. So there were two very important areas of successful international coordination in this period.

Meanwhile we had restored price stability and I felt emboldened at one point at the end of the 1980s to give a lecture about the triumph of central banking. I put a question mark behind it, but I think there was a certain amount of truth to it at that point in time. What we are facing now is the question of whether that can continue, whether we are retreating, and what is going on at the moment.

Let me be brief: for all the triumphs of central bank cooperation, for all the triumphs in terms of price stability, in my view, there has not been any great success in exchange rate management. It strikes me as a very odd thing to have so much volatility in exchange rates in a world that is becoming globalised and interdependent financially. I had the pleasure of listening to Thomas Friedman, the New York Times columnist and author of “The World Is Flat”, giving an eloquent speech the day before yesterday on this point. When you listen to him talking, in a very clear way, about the integration of world business and of world financial markets, and the growing importance of China, India and other Asian and Latin American countries being integrated into the supply chain of the US economy, you cannot but wonder how violent fluctuations in exchange rates which range, as you well know, to 40 or 50%, can possibly make sense in that world. Well, my answer to that is, they do not make sense, but the relevant question is, what are you going to do about it?

It does not strike me that central banks are working hard on this problem. Neither do I have any sense that governments are working hard on this problem; in fact, a lot of them think it does not even exist. But I suggest to you that the market is working hard on this problem. And part of the explanation of what is going on in terms of the accumulation of reserve assets and the private flows of money to the United States, I would suggest to you, is the market reacting with the continued internationalisation of the dollar. It is happening to an extent, and even beyond what has happened before, as a kind of quasi substitute for a world currency. That is the closest the emerging world can come to it. Currently, there is considerable concern in Asia about trying to achieve some monetary stability in that part of the world, in a way very similar to what went on in Europe 20 years ago, although it will be much harder to achieve a similar outcome. In fact, I do not think that any such effort is going to be successful until a real anchor emerges for those Asian currencies, which presumably will be either the yen or the yuan. I won't place my bets - but it will be one or the other - I am convinced that it is going to happen.

At any rate, there is a great desire for more stability in this area, and this need is making itself felt through the use of the dollar multinationally. It may also develop into the use of the euro regionally, the use of the yuan or the yen regionally in Asia, and the use of the dollar, of course still regionally, in the Americas. And that is the way we are drifting. The question is: is that a good way to drift? Well, I can think of worse ways to go, that much is for sure. This would provide a certain amount of stability, and, incidentally, it would show the whole question of cooperation in the monetary world and the economic world in a slightly different light. Can one expect real cooperation between big regional blocs when they themselves sense that they are relatively self-sufficient and therefore need not be too concerned about exchange rates and other matters?

I think that is a wrong perception, but it is clearly an existing one, and perhaps one that may have political as well as economic consequences that may lead to a different kind of world than the one we envisaged with pure globalisation and internationalisation. I suspect it is some kind of a half-way house - it may not be very satisfactory in the long run, but my sense is that this will be the challenge for policymakers, whether they are central bankers or others, in the next few decades: is the world going to move apart into big regions or will the advantages of a more full-blown internationalisation be achieved?

I am not necessarily thinking of a great new world currency - I keep saying that that is not going to happen in my lifetime; my lifetime is getting shorter - and it probably will not happen in the lifetime of any of the people in this room either. However, the fact remains that you do have some approximation to that in the use of the dollar, which puts a very heavy burden on policymakers in the United States as to whether this one country, big and powerful as it is at the moment, can sustain not just the advantages but also the burdens of a world currency. I do not know the answer to that, but I know that there is one thing that I would be concerned about, as it may lead to a crisis instead of a smooth adjustment to the present problem. And that is some sense that the US economy itself, and particularly the price level of the United States, will not remain stable. That, I think, is the challenge, given explicit international cooperation or not. Instability in the United States could be the thing to bring down the whole arrangement. I am not predicting it - I am just saying that today, this is more important than it has ever been in this kind of integrated world economy.

Comments

Yutaka Yamaguchi[1]

There are a number of aspects of central bank cooperation. Today I will focus on the coordination of monetary policy.

The present international economic scene strikes me with a strong sense of déjà vu, for it has some major features in common with the mid-1980s. The US current account and fiscal deficits are large; the dollar is relatively strong, and the "strong dollar policy" is still advocated by the US Administration, albeit more in rhetoric than in substance; the view persists in the market and financial community that a major currency realignment is inevitable; and protectionist sentiment is also on the rise. Thus the only difference between the two scenarios appears simply that China has replaced Japan as the main target of adjustments in trade and exchange rates.

But, of course, there are other important distinctions. Then, the world was simpler. A limited number of developed economies had only to ease imbalances between themselves. Today, economic power is more widely dispersed. Any meaningful dialogue would have to involve major emerging economies. Even among the developed countries, the balance of economic power has shifted substantially in the last twenty years. An irony is that the preeminently competitive country is running the largest external deficit ever.

The sustainability question of external imbalances has been with us for some time now. Views differ among economists and policymakers as to whether an unwinding of imbalances is likely to be violent or benign. But, as the US current account deficit keeps growing, many financial institutions treat it in stress scenarios as the largest risk to the global economy. In that sense, it could be considered a "high-probability, high-impact" event in the risk management paradigm of monetary policy. Yet, I see little genuine sense of urgency to address the perceived risk, either on the US or on the surplus countries side.

In the US, as long as the capital inflow is sustained, there seems to be no strong incentive to augment domestic savings by, say, putting a brake on fiscal expansion. When the leadership is not forthcoming from the US to take actions either domestically or in internationally coordinated form to improve the imbalances, no other country is capable of offering it. This is even more so today than in the 1980s, when the European and Japanese economies had greater capacity to absorb external shocks. To be realistic, the odd combination of the US external deficit and the relatively strong dollar has provided the "greasing-the-wheel" effects for the rest of the world. Moreover, in some surplus countries like Japan, effective political forces or domestic constituencies that used to push expansionary spending policy in the name of correcting the imbalances no longer exist. This option is totally unrealistic today anyway, given the appalling public debt situation.

But, from the central bank perspective, there are some positive facets in the present situation. They have to do with (a) learning from the Plaza-to-Louvre coordination experience, and (b) the evolution of central banking in recent years.

To me and many of my former colleagues of the Bank of Japan, monetary policy under the Plaza-Louvre process represents a failed model of international cooperation. The coordination process, particularly when translated into a domestic context, effectively constrained the flexibility of monetary policy. Under international and domestic pressures, the Bank of Japan progressively eased in 1986 and 1987. And, perhaps more importantly, it failed to reverse course in 1988 even while the US Fed began to tighten. This failure to act contributed to a perception that monetary conditions would stay easy. By then, industries had largely overcome the 50% appreciation of the yen. Confidence reemerged. Under the influence of all these forces, asset markets were caught up in euphoria. The rest is history.

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[1] Former Deputy Governor of the Bank of Japan.

Thus the process as well as the consequences of our monetary policy left a serious lesson. Obviously we never know the counterfactual: what would have happened if the Plaza-to-Louvre process had never taken place. In fact, I believe it would be too simplistic to paint the Japanese bubbles as having originated solely in the easy money policy of the time. Nonetheless, one always wonders if monetary policy couldn't have been different.

I want to pursue this episode a bit further and try to generalize why the coordination in the mid-1980s failed. Yes, the external pressure on Japan to ease monetary policy was real. But why was it accepted by the Japanese side? First, the Bank of Japan was asked, to put it mildly, to serve the national priority of the time. Historically, this priority for the central bank was typically war-financing. For Japan in the 1980s, the national concern was the trade war or how to moderate trade tensions.

Second, as a result, the Bank of Japan was obliged to pursue atypical and impossible goals for monetary policy: above all exchange rate stabilization and reduction of the external surplus. The main reasoning for cutting interest rates in 1986 and 1987 seems to have been well grounded in that it was thought that such easing would stimulate domestic demand in a time of extreme uncertainty, and thus lower the current account surplus. It became increasingly difficult in 1988 to justify easy money in the same vein. In the domestic context, it was argued by some that the Bank should keep interest rates low for the benefit of international cooperation: ie to prevent a fall of the dollar. The notion of SNIG, or sustainable noninflationary growth, was widely accepted in the international community as the desirable macroeconomic policy goal. But it had only weak domestic constituency, and easily gave way to more pressing agendas. It took a bursting of bubbles and the rewriting of the central bank law for the concept of SNIG to settle in.

Third, it probably mattered that the Bank of Japan was not independent then. I say "probably", because I am aware of the whole set of constraints which an independent central bank would still have to face. But I suspect an independent Bank of Japan would have followed a somewhat different trajectory in those crucial years.

The Japanese episode could serve as a lesson for some other central banks. For example, Chinese monetary policy today appears to share some major features with Japan in the 1980s. But I trust that our friends at the People's Bank have studied the Japanese experiences in detail.

Turning to the evolution of modern central banking, it has three major features: (a) establishing price stability, or maximum economic growth under price stability, as the objective of monetary policy; (b) granting independence to the central bank to meet the objective; and (c) conditioning that independence on enhanced accountability.

I agree with other participants in this conference that the recent evolution tends to distance central banks from Plaza-type coordination. Their mandate has a clear domestic orientation. It is consistent with the "put one's own house in order" principle. External factors, important as they are, usually enter actual policy formulation to the effect of influencing output and prices. Thus price stability-oriented monetary policy would make a Plaza-Louvre style coordination extremely unlikely. This, in my view, is the right way to learn from history.

Central bank independence and accountability are also of a domestic nature. Monetary policymakers try to retain maximum flexibility in this uncertain world. International agreements tend to limit that flexibility. Policymakers also have to be accountable to their countrymen, not to a vague "international community". They will likely become more sensitive to whether their actions in the international sphere can be fully defended in terms of bringing benefits to the national economy and its citizens.

This observation brings me back to where I started. Current account imbalances are being left in a state of benign neglect. The "standard" menu of actions to help correct them is regularly cited in the G7 statements and well known. But the problems facing their implementation are equally well known, as follows. (a) There is little enthusiasm on the part of US policymakers for increasing savings by deliberately and forcefully cutting the budget deficit. (b) Structural reforms to enhance growth in Europe and Japan can only be a slow process. Moreover, the actual effects of such efforts, as well as the time lags involved, are unpredictable. (c) Fiscal policies in both Europe and Japan have lost any capacity to aggressively stimulate economic growth. Given these practical constraints, it follows that it could be market forces which trigger an external adjustment process.

Central banks have already sounded alarms in various contexts on a need to raise savings, accelerate structural reforms and allow greater flexibility in exchange rates. Clearly central banks alone can make little direct contribution to improve the status quo. Even with respect to exchange rate "management", their responsibility is often shared with the finance ministry or simply advisory. But, given a looming uncertainty associated with an adjustment process going forward, central banks, particularly in countries that have conducted currency market interventions more often than others, might want to consider or advise the government to “manage” exchange rates, when at all possible, to move more consistently with external adjustments. Such “management” in surplus countries would include accepting greater flexibility of their currencies against the US dollar in times of capital inflow, provided that such a move is deemed consistent with fundamental economic developments.

Let me conclude by commenting on a couple of areas where cooperation can be enhanced, one in monetary policy and another in financial market activities.

First, I agree with other participants in this conference that central bank cooperation, or at least the core part of it, is essentially an exchange of views and information, whereby the participants incorporate others’ economic and policy judgements as they formulate their own monetary policy. Add to this the fact that central banks around the globe are increasingly pursuing similar objectives, namely price stability or maximum growth under price stability. Those objectives may never fully converge. Nonetheless, sharing broadly similar objectives has made the exchange of information between central banks more meaningful and relevant. The ongoing dialogue is nonbinding, but frequent and deep. This is a state of cooperation without concerted actions. It is perhaps as far as central banks could go unless they were to be given a fundamentally different mandate. But one need not regard this as a “limitation” to cooperation. The challenge is to keep the quality of dialogue at the highest possible level.

The second area for enhanced cooperation is activities in the financial markets, especially when major shocks hit. In the integrated financial markets of today, shocks can easily and swiftly propagate to trigger strains and crisis on a global scale. These have to be dealt with jointly by central banks, supervisory authorities and ministries across national boundaries, often in cooperation with the private sector, involving a host of difficult conceptual and practical issues.

What I want to stress in this context is the importance of the “nuts and bolts” of central bank operations in preserving systemic stability. Without the precise knowledge of how markets transfer risks, process payments and propagate shocks, central banks could not function effectively in times of crisis. This is where they have a comparative advantage. Yet, there still seem to be areas in which central banks’ knowledge has to be further enhanced.

A major practical challenge for central banks to make progress in this vein is the increasing difficulty of obtaining accurate, up-to-date information and data. Markets are evolving fast. By definition, there exist only fragmented data at best for the market frontier. Ever intensifying competition appears to be making the major market players more reluctant to provide information on their activities to the public sector. They seem to have little incentive to do so. That incentive would have to be provided by the collective power of persuasion of central banks. Central bankers want to understand the global financial markets better, and take prompt actions if necessary to defend systemic stability. Hopefully this collective motive and will, when understood well by market players, may prove effective in building constructive relations between central banks and market participants.